

Preface and Acknowledgements

“Corporate governance” emerged as a practice area at the unforeseen intersection of state corporate law, federal securities law, and Delaware tort law, as lawyers and their clients realized no single body of law covered the complex and inter-connected issues that modern publicly traded companies face.

This book is intended to provide directors—and attorneys advising directors—with information on the policies and underlying issues that shape director fiduciary duties and the other corporate governance requirements. It describes the legal and economic context in which these governance requirements arise, and it also describes the implementation details that can affect specific governance related decisions.

This book also provides sample summary materials in the form of Power Point presentations that attorneys can use as starting points to prepare training or explanatory sessions before a board or management. While none of the material in this book constitutes legal advice respecting any specific factual situation, the presentation templates are intended to help attorneys organize and prepare materials for their clients on governance issues. The presentations also provide practitioners with a summary overview and refresher on the governance topics covered in the book.

This book grew out of my experience as general counsel to a public company in the mid-1990s. While I was armed with a small library of

treatises and handbooks, I found that no matter how well a writer summarized a legal matter, the specific facts of any question forced me to seek out the text of underlying cases, statutes and regulations. However, in those pre-Google, dial-up modem days, legal material was not as available or as readily searchable online as it is today.

Prior iterations of this book contained digital copies of source material. This book omits source material, but includes citations so readers can locate it online. The book's citations are made in the summary form that securities and corporate law practitioners use in speaking among themselves, rather than formal Blue Book style. For example, Section 16 of the Securities Exchange Act of 1934, as amended, is not cited as "15 U.S. Code § 78p." It is simply cited in the book as "Section 16." I selected this format as a way to make references more easily recognizable to practitioners. While that choice does stick any litigators or academics using this book with a bit of extra work to find the formal citation, the Internet has made that legal research simpler than in the past.

I also recommend another book published by the ABA, "The Corporate Directors Guidebook," prepared by the Corporate Laws Committee of the Business Law Section of the American Bar Association. It provides broad general advice to boards and individual directors—and to their advisors—on what directors of public companies must do in order to meet their obligations.

For practitioners who want to maintain or expand their expertise in corporate governance, I recommend joining the American Bar Association Business Law Section's Corporate Governance Committee ("CGC"). The CGC programs and materials are excellent. If you attend the meetings, you will be inspired and energized by the talent, experience and wisdom possessed by lawyers who are members of the CGC.

I thank the individuals who helped me prepare this book and its predecessors: Stewart McDowell, Steve Dorian, Debbie Elder, Carrie Arnold, Megan Lane, Ilya Filmus, Joanne Tan, Ann Poole, Kelli Christiansen, Betty Barth, Sherry Tabaczynski, Elizabeth Jackson, Ashley Ray, Caroline Colangelo, and Justin Dela Cruz. Particular thanks goes to the ABA's Susana Darwin, for her long-time guidance and excellent insights. I also thank Liane Anderson, my wife, for her patience, support and love.

Corporate Governance in Context

“Corporations are legal devices for assembling and organizing capital, labor, and other resources to produce and sell goods and services. . . . [T]he broad policies, strategic plans, and day-to-day decisions in large publicly traded corporations are largely controlled by professional managers. These are typically individuals whose own at-risk assets are small relative to the assets they administer. Thus the central problem in any corporate governance system is how to make corporate executives accountable to the other contributors to the enterprise whose investments are at risk, while still giving those executives the freedom, the incentive, and the control over resources they need to create and seize investment opportunities and to be tough competitors.”

—Margaret Blair, *Ownership and Control* (1995)

Corporate managers act under the supervision of boards of directors elected by shareholders. “Corporate governance” refers to the many overlapping laws and private arrangements by which the managers, directors, and shareholders interact on how an individual corporation’s business is run.

Corporate governance, in turn, is part of the legal and economic system supporting the existence and operation of the capital market.

The capital market is the global set of trading relationships that set the value of currencies, commodities, governmental and private sector debt instruments, interest rates, equity securities, and derivative financial instruments. Investors rely on an active and liquid capital market to store and invest wealth.

Corporate governance rules provide infrastructure support to the capital market: just as roads and rail lines need to be in place to move goods and people effectively, the law of corporate governance supports investment by channeling the behavior of corporate managers along paths that investors can understand and use to direct capital.

Corporate laws allocate rights and responsibilities for corporate operations among managers, directors, and shareholders. Under the securities laws, publicly traded companies internalize the costs of providing information to investors, facilitating trading in the public markets. The marginal cost of securities law compliance borne by each public company results in a collective investment in a vital and viable capital market. Even companies with no immediate need to raise capital bear these costs. Access to the public markets provides a ready pipeline to meet future capital needs, provides liquidity for the shares owned by investors and used as compensation to managers, establishes company shares as currency for corporate transactions, and is a handy way to keep score on how the company is doing.

Sometimes issues in corporate governance structure are resolved by market forces, or in litigation. In other cases, state or federal regulation is needed in order to create a common good through universally applicable rules, particularly where free riders would undermine a voluntary compliance system.

When corporate governance goes wrong—as it did in the cases of Enron, WorldCom, and numerous other companies in the early 2000s—the impact can be devastating for investors in the affected company, and generate negative ripple effects in the capital market.

Rules about governance are woven into the fabric of capitalism. Capitalism as a productive system has been highly successful. It also evolves as conditions evolve. In a highly technological society, it would be more

shocking if capitalism did not change, than to see that its governing rules get tweaked now and again in response to changing conditions.

The need to change governance rules occasionally is not an attack on capitalism, although opponents of change often characterize it that way.¹ At the same time, absent the need to respond to a crisis, rules supporting trillions of dollars of stored investment wealth need to be changed carefully, to minimize unforeseen negative consequences.

Investors have changed substantially in the 80 years since the securities laws originally were adopted. Holders of securities tend not to be primarily private individuals, but rather are mutual funds, pension funds, endowments, and insurance companies.² The reasons for these changes over the past 80 years are many. For example, workers who in a prior generation might have expected a pension for years of company service are now “forced capitalists”³ who rely on a 401(k) or government investment funds to provide future retirement benefits.

The various shareholding institutions, in turn, will have their own standards and requirements for providing returns and liquidity to their

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1. The Securities Act of 1933 (“1933 Act”) regulated the disclosures to be made with respect to the issuance of securities. The Securities Exchange Act of 1934 (“1934 Act”) regulated exchanges, brokers, and disclosures to be made with respect to trading securities in the secondary markets. The financial services industry at the time—which had just gone through the 1929 market crash and was suffering with the rest of the country through the Great Depression—vociferously opposed the “socialist” regulatory requirements set by the federal government. See Chapter One of Joel Seligman, *The Transformation of Wall Street* (3d ed.) (Wolters Kluwer, 2003) for a fuller discussion of the then prevalent manipulations in the securities market preceding the 1929 market crash, and the fervent desire of the financial industry that the status quo be allowed to continue lest capitalism founder, including declaring that promoters of securities law reform were Bolsheviks. See also Michael Perino, *The Hellhound of Wall Street: How Ferdinand Pecora’s Investigation of the Great Crash Forever Changed American Finance* (Penguin Press, 2010). Any organization needs to adapt to changing conditions, and honest critiques aimed at producing improvement help the organization sustain itself and prosper. Human nature is less changeable—those who gain from the status quo often defend it even against their own long-term interests. Changes to the securities laws invariably are accused of being “anti-business” or “anti-capitalist.”
 2. “Report Of The Task Force Of The ABA Section Of Business Law Corporate Governance Committee On Delineation Of Governance Roles & Responsibilities” at 111 (Aug. 1, 2009).
 3. Leo E. Strine Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance* (2007), Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series available at http://lsr.nellco.org/cgi/viewcontent.cgi?article=1373&context=harvard_olin.

beneficiaries. Nonetheless, the fundamental economic and governance questions posed by academics 80 years ago, just at the time the securities laws were adopted, remain substantially true.⁴

Management needs a certain amount of leeway in solving operating issues—monitoring and control costs to wring out every penny of inefficiency would outweigh the benefit at some point. Each shareholder is left for itself to sort out whether the cost of providing that leeway is too great or is acceptable. This gives management negotiating room to seek compensation that may not be the optimum amount from the shareholder's point of view. To put the question broadly, is it acceptable if each shareholder loses a penny a share in earnings, but management gathers those millions of pennies to itself?

In that light, it is helpful to think of the board as mediating between the demands of the capital market (to have its returns protected) and the demands of management. As a general rule, no single shareholder will be willing to bear the entire cost of setting out to assume control of a corporation to improve its operations or limit costs, when that shareholder would have to share the resulting benefits with all of the other shareholders.

Because each company is different, with different opportunities, different resources, and different evaluations of risk and reward growing out of its unique circumstances, no single approach can solve all governance problems. Even where a single general rule exists—such as the requirement that directors act as fiduciaries in the best interests of shareholders—the application of that rule in any individual case will be subject to interpretation.

As with all things, the devil is in the details. In the case of corporate governance, the details are the statutes, regulations, court decisions, exchange listing requirements, directors and officers (D&O) insurance policy requirements, Securities and Exchange Commission (SEC) enforcement programs, internal corporate policies, codes of ethics and committee charters, investor policies, and “best practices” recommendations that are brought to bear on each company. This book addresses not only the laws affecting independent directors and corporations but also the broader context in which these laws have arisen and will be interpreted.

4. Adolf Berle & Gardiner Means, *The Modern Corporation and Private Property*, (2010, Transaction Publishers, original edition published 1932).

Rarely is a question in corporate governance settled by reference to a single source of authority. This book will refer to the multiple sources of authority that affect key corporate governance undertakings.

Finally, while corporate governance describes a process, it does not guarantee a result. A board of directors with immaculate corporate governance processes might still make bad business decisions, and a board with weak governance processes might make excellent decisions.

Governance practices are not an end in themselves, nor are they merely nuisances to be gotten through as quickly as possible. While this book focuses on many of the details of governance, readers are encouraged to keep in mind the big picture of the role in governance in promoting the health of capitalism.

Ownership, Control, and the “Agency” Issue

Unlike sole proprietorships, partnerships, or family businesses, where the owners tend to be the same people as the managers and the operators, corporations are owned by a dispersed set of investors, and are managed and operated by a professional management group.

This gives rise to what is generally called the “agency” issue: the risk that the shareholders’ agents, the corporate managers who have control over the corporate resources on a day-in, day-out basis, will be tempted to use those resources for their own gratification, rather than in the best interests of the investors, who are the owners of the corporation.

Contributing to this risk is the economic reality that even though investors acting together might obtain better returns from stronger monitoring of management, each investor has a relatively small stake in the corporation, and the cost to a single investor of monitoring management would likely outweigh that investor’s increased return.

Accordingly, the job of overseeing managers falls to the board of directors elected by the shareholders. Historically, once companies became self-sustaining pools of operating assets, their boards became self-perpetuating clubs of insiders who selected one another to serve as directors, executives, bankers, and vendors. Over the past century, corporate and securities laws developed in reaction to abuses by the insiders who controlled corporate assets.

Corporate management historically has had a significant hand in selecting the board. A board member who was charged with holding management accountable for its operation of the business was at the same

time beholden to management for the board position and, in many cases, for other business from the corporation as well. This provided directors tasked with overseeing management's use of corporate assets with an incentive to turn a blind eye to management self-dealing.

In the mid-1970s, Professors Jensen and Meckling⁵ identified three categories of agency costs: monitoring (including the costs of compensating agents); bonding (providing remedies for violations of the requirement to tend to the owners' interests); and residual costs (the economic loss to shareholders resulting from the difference between the way the agent performs compared to performance that would maximize the owner's welfare). Historically residual costs included outright expropriation of value by managers and insider trades that victimized shareholders.⁶ Under that definition, residual costs would include, for example, the losses incurred by shareholders in the financial crisis, in cases in which managers used risky corporate strategies to pursue compensation targets, and the financial harm of failed strategies fell mainly on shareholders.⁷

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5. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, *Journal of Financial Economics*, Vol. 3, No. 4 (1976).
 6. Jensen & Meckling. http://www.delvesgroup.com/wp-content/uploads/2010/08/Agency-Theory-Summary_Delves-Patrick.pdf.
 7. See *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (2011), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.